EXHIBIT C

HUD UNDERWRITING GUIDELINES

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The loan underwriting policies of the CITY/COUNTY of ________ are designed to insure the Program’s on-going viability, assist businesses that could not proceed without the RLF, and ensure that the RLF assistance is “appropriate.”

HUD UNDERWRITING GUIDELINES:

The CITY/COUNTY of _________ has adopted the HUD underwriting guidelines to determine whether a proposed CDBG subsidy is **appropriate** to assist the business expansion or retention. In addition, the project will be reviewed to determine that a minimum level of **public benefit** will be obtained from the expenditure of the CDBG funds in support of the project.

The objectives of the underwriting guidelines are to ensure:

- that project costs are reasonable;
- that all sources of project financing are committed;
- that to the extent practicable, RLF funds are not substituted for non-Federal financial support;
- that the project is financially feasible;
- that to the extent practicable, the return on the owner’s equity investment will not be unreasonably high;
- that to the extent practicable, RLF funds are disbursed on a pro rata basis with other financing provided to the project; and
- sufficient public benefit will be received from the expenditure of RLF funds.

Project Costs are Reasonable

All project costs will be reviewed for reasonableness, and to avoid providing either too much or too little RLF assistance. The amount of time and resources expended evaluating the reasonableness of a cost element shall be commensurate with its costs. In some instances, it will be necessary to obtain third-party, fair market price quotations or a cost element. Particular attention will be documenting the cost elements in a non arms-length transaction.

Procedures:

1. Start with Sources and Uses of Funds.

2. For each Use of Funds, determine if costs are reasonable.

   a. For construction, machinery, equipment, determine if the costs are estimated by a third-party (e.g. architect, engineer, equipment supplier, etc.) Determine if the estimates are included in the application. Determine if the contingency is adequate.

   b. For land, determine if the price is based upon fair market value. If not, determine what is the fair market value and how the price was determined. Obtain an appraisal or an opinion of fair market value.

   c. For development costs (building fees, architectural/engineering costs, financing costs, franchise fees, etc.), determine if these costs are itemized and supported by contracts or other documentation.

   d. For working capital, compare the amount of working capital to industry averages, risk, historical needs of the business and the projected need. Analyze business financial statements, projections, operating cycle and financial ratios.

3. A higher level of review will be required if there are no third party estimates.

4. Sources of information:

   - Sources and Uses of Funds statement
   - Financial Statements and Projections
   - Industry Averages (Robert Morris)
   - Third party costs estimates
   - Building Department/Public Works
   - Realtors/Appraisers
   - Architects/Engineers
   - Contractors
   - Equipment Suppliers
   - Other similar projects

Commitment of All Sources of Project Financing

Prior to the commitment of RLF funds to the project, a review shall be conducted to determine if sufficient sources of funds have been identified and committed to the project, and the participating parties have the financial capacity to provide the funds to ascertain if the project is viable and will move ahead in a timely manner. In certain circumstances, the RLF may commit its funds in advance of final commitments from other funding sources. However, to conduct the underwriting analysis, the approximate terms and conditions of the other funding sources should be known. Final commitment from the other funding sources, with substantially similar terms and conditions as used in the underwriting analysis, will be required prior to any loan closing or disbursement of funds.

Procedures:

1. Start with Sources and Uses Form.

    a. For all sources of funds, determine if there is evidence verifying commitment or intent to commit.

    b. For debt sources, be in receipt of letters of intent or interest which specifies the level of commitment and terms/conditions of the loan. The proposed terms should be reflected in the business projected debt schedule and in the financial projections. Determine if actual loan packages have been submitted to lenders.

    c. For equity sources, determine if the equity injection is verified on the business or personal financial statements. Or if the equity is provided by an investor, obtain evidence of the level and terms of commitment(e.g. letter of intent with accompanying financial statement verifying availability of funds).

2. Sources of information:

    - Sources and Uses of Funds
    - Business and Personal Financial Statements

- Letters of intent/interest from lenders, partners and investors

Avoid Substitution of CDBG funds for Non-federal Financial Support

The project will be reviewed to ensure that, to the extent practicable, RLF funds will not be used to substantially reduce the amount of non-federal financial support for the project to make the most efficient use of the RLF funds.

In order to receive RLF funds a project must have a "financial gap." This gap must be documented. There are three types of financial gaps, two are discussed below, and the third is discussed under the criteria of "Return on Equity Investment." One project may have two different gaps. The types of gaps are as follows:

A. <u>Unavailability of Capital</u>: The project can afford the cost of financing, but is unable to obtain the funds from either debt and/or equity sources. In regards to debt, the gap may be a result of a lender's loan to value requirements or the inherent risk of the industry or project. For example, the lender will only loan 70% of the project's costs. In this case, the business may not have the cash to bridge the gap, or if the business bridges the gap, it's cash flow may be so restricted as to jeopardize the business. In order to document this gap, several steps need to be undertaken. The lender needs to be contacted to determine if there is any ability to increase the size of their loan. Other lending sources, both public and private, need to be explored. This includes looking at the business owner(s) personal financial statement for potential funds, including home equity loans. Finally, in addition to looking at the business and personal financial statements and tax returns, a pro forma cash flow analysis needs to be prepared and analyzed, with and without RLF funds, to demonstrate the gap.

The terms and conditions of a loan under this gap analysis should be comparable to the market.

B. <u>Cost of Capital</u>: The project cannot support the interest rate, loan term and/or collateral requirements of a lender. In analyzing this gap, discussions with the lender are important to determine any flexibility in terms. A single project may not be able to support the rate, terms and collateral requirement, or may just face a single hurdle. In addition, the gap may only exist in the early years of the project. To determine the gap, business and personal financial statements and tax returns shall be analyzed. Sources of equity shall be explored. Public and private funding sources that would bridge the gap shall be evaluated. Pro forma cash flow analysis shall be developed with and without the RLF funds to demonstrate the gap. Depending on the gap, the terms or rate shall be adjusted to a rate that allows the project to proceed but is not too generous. Terms can be adjusted to allow for deferrals of principal and/or interest, or to allow loans to be amortized over a longer period. Interest rates can be adjusted, including increases in the rate over time as cash flow allows.

Procedures:

1. Review the Sources and Uses to determine if other sources of funds are available (e.g. SBA, RD, business, personal or investor equity, etc.)

2. If the need for RLF funds is based upon a lender’s loan-to-value requirement, determine if this requirement is reasonable and based upon the project’s risk and location.

3. If the need is based upon the cost of funds, then conduct a review of the financial information to validate the need for the RLF funds.

    a. Review historical and projected financial statements

    b. Determine if revenues, expenses, debt service, officer’s salaries, owner’s draw, net operating income are reasonable via a comparison of historical financial information and industry averages (Robert Morris).

    c. Review projections with and without CDBG funds. Determine if the project can support more debt within prudent underwriting guidelines. Determine if net operating income, owner’s draw, and the degree of equity participation is reasonable.

4. Sources of information:

- Sources and Uses of Funds
- Financial Statement
- Projections
- Industry Averages (Robert Morris)
- Other Financing Programs
- Lenders

Financial Feasibility of the Project

Each project will be examined to determine the financial viability of the project, and thus the reasonable assurance that the public benefit will be realized. The current and past financial statements of both the business and individuals must be analyzed. Income and expense costs shall be evaluated and compared historically, where applicable, and compared to industry averages (using guides such as Robert Morris' Annual Statements Studies). Project costs, including both hard and soft costs, must be determined to be reasonable. Accurate project costs are vital to determining project feasibility.

As part of the financial analysis, the past, current, and projected financial data shall be analyzed to determine if the job estimates are reasonable and supportable. Labor costs shall be looked at the break-even point. In addition, labor costs shall be checked against industry averages. Variations should be explained in the loan analysis.

The terms and conditions of the RLF loan must be "appropriate." In general, the interest rate shall be set at a rate where available cash flow is able to meet debt obligations, after other obligations are met, with enough cash flow remaining to operate successfully. The loan term typically is based on the asset being financed. The term should not exceed the economic life of the asset being financed. However, a longer loan amortization schedule, with the loan due at the end of the economic life may be justifiable.

Each loan shall include a written explanation of the "appropriate" analysis that was undertaken, and the reason the terms and conditions of the loan were approved.

Financial Analysis. Historical and projected financial statements will be subject to financial analysis to determine the gap, and structure the terms and conditions of the RLF loan, as discussed above, but also to determine that the project is feasible. In addition, using prudent underwriting guidelines, demonstrating that the proposed loan is of sound value and that past earnings and future prospects indicate an ability to meet debt obligations out of profit.

Information that will be required to be submitted by the applicant will depend on the project, ownership structure and whether it is an on-going or start-up business.
The financial analysis will differ depending on whether the business is a start-up or existing business. The analysis will include for existing businesses a spread of the current and historical financial statements to determine trends. The pro forma statements will then be compared to these past statements. Key financial ratios will be analyzed. The statements and key ratios will be compared to industry averages. For start-up businesses, the projections will be analyzed and key ratios developed, and both compared to industry averages.

Key ratios that will be analyzed include:

<u>Current Ratio</u>: current assets/current liabilities. This ratio is a <u>rough</u> indication of a firm's ability to service its current obligations. A ratio of 2:1 is considered secure.

<u>Quick Ratio</u>: cash and equivalents plus accounts and notes receivable/current liabilities. A ratio of 1:1: usually indicates ample liquidity.

<u>Cash Flow Coverage</u>: net profit & depreciation & depletion-amortization expenses/current portion of long term debt. This ratio is a measure of the ability to service long term debt.

Another coverage ratio is earnings before interest and taxes/annual interest expenses. This ratio is a measure of a firm's ability to meet interest payments. A cash flow coverage of 1.25 debt service shall be used as a guideline.

<u>Debt to Worth</u>: total liabilities/tangible net worth. This ratio shows the relationship between debt and a businesses net worth. A lower ratio is an indication of greater long-term financial safety and greater

flexibility to borrow. In general, a debt to worth ratio of higher than 5:1 should not be exceeded as a underwriting policy. There are exceptions when the industry average is high due to its capital intensive nature or when projections show the ratio lowering quickly.

Collateral Coverage: The value of collateral as compared to the amount of the loan. Typical bank underwriting guidelines suggest that 125% of loan balance be used. However, this is highly dependent on the quality and security of the collateral. In addition, collateral requirements are a cause of "financial gaps." The RLF shall use 100% as a guideline, which shall only be lowered with specific and detailed analysis and explanation.

Break-even Analysis: The analysis of the project's ability to support the projected labor costs and additional debt service at its break-even point (BEP) will be analyzed to determine what proportion of the jobs can be supported at that BEP. This will serve as a worst case look at the business' prospects for success, ability to service new debt, etc.

The financial and ratio analyses must be supported by the business plan. The business plan must provide a clear understanding of the project, competition, market strategy, sales estimates, management capacity and other factors.

Lastly, to ensure project feasibility, an evaluation will be conducted of the experience and capacity of the business principals to manage the business and achieve the projections.

Procedures:

1. Perform financial underwriting analysis.

    a. Spread historical financial statements and projections. Identify any significant differences. Compare to industry averages.

    b. Review assumptions to projections. Determine if projections are reasonable and supported by market studies, business plan, and historical trends.

    c. Review cash flow for project. Determine if there is adequate working capital.

d. Determine break-even point for project, and how much the projections are above the break-even point. Determine if the public benefit will be realized at the break-even point.

2. Review the business plan, market information, historical financial statements, projections, ratio analysis, spread sheet analysis and management capacity to determine the project feasibility.

3. Sources of information:

- Historical financial statement
- Financial Projections
- Business plan
- Market and industry information
- Industry Averages

Return on Equity Investment

The return on equity investment is the amount of cash that the investor/business owner is projected to receive in relation to their initial equity. For a sole proprietor, this equates to salary plus net income. To the extent practicable, the RLF should not provide more than a reasonable return on investment to the business owner. This will help ensure that the RLF will maximize the use of RLF funds and not unduly enrich the business owner(s)/investors(s). However, care shall be taken to ensure that the rate of return will not be too low, so that the business owner's motivation remains high to pursue the business with vigor.

If the project's financial returns are projected to be too low to motivate the business and/or investor to proceed with the project, then the risks of the project outweigh the returns. An inadequate rate of return, adjusted to industry and locational risks, is a third method to determine the gap appropriate to be funded with RLF funds. To analyze this gap, the projected return on investment must be compared to the return on investment on similar projects. If it is shown that a gap does exist, then the RLF financing rate and terms must be set at a rate which provides a return equal to the "market rate." Real estate appraisers and lenders are important sources of information on "market rate" returns.

Procedures:

1. Review projections.

   a. Review revenues, expenses (including officers' salary/owners' draw), debt service and net operating income. Compare to historical financial information and to industry averages. Determine if these items are reasonable.

   b. Review indicators of owners' return on equity, including officer's salary, owners' draw, and net operating income. Given the project's risk and local conditions, determine if the return on equity is reasonable compared to industry averages.

2. Review the business and personal obligations. Determine what return on equity is necessary to meet personal and business obligations.

3. If return on equity is above industry averages, adjusted for risk and local conditions, take steps to reduce the return to within a reasonable rate by restricting owners’ draw/officers’ salary, or adjusting the RLF loan terms.

4. If return is below average, adjust RLF subsidy to bring the rate of return closer to the industry average.

5. Sources of information:

   - Financial projections
   - Historical financial statements
   - Personal financial statements
   - Industry averages

Disbursement of RLF on a Pro Rata Basis

To the extent practicable, RLF funds should be disbursed on a pro rata basis with other funding sources to avoid placing RLF funds at a greater risk than other funding sources. When it is determined that it is not practicable to disburse RLF funds on a pro rata basis, other steps shall be taken to safeguard RLF funds in the event of a default.

Procedures:

1. Review Sources and Uses of Funds. Determine when RLF funds will be expended as compared to other funds.

2. Determine other funding sources’ policies towards expenditure of funds. These policies may require the use of RLF funds first. If so, negotiation with other funding sources may be needed.

3. If RLF funds are to be expended first, consider actions to safeguard RLF funds (e.g. performance or completion bonds).

4. Sources of information:

   - Sources and Uses of Funds
   - Construction Contracts
   - Lender Requirements/Policies

Standards for Evaluating Public Benefit

Each project will be reviewed to determine if a minimum level of public benefit will be obtained from the expenditure of RLF funds. The minimum standard is:

> The project must lead to the creation or retention of at least one full-time equivalent job per $35,000 of RLF funds used.

Procedures:

1. Review historical financial statements.

   a. Review historical labor costs as a percentage of revenues. Compare the percentage to projected labor costs. Determine if the two figures are consistent. If not, obtain an explanation.

   b. Determine if the number of projected jobs is consistent with the projected increase in labor costs. Compare the labor cost percentage to industry averages.

2. Review the projections.

   a. Determine if the assumptions used to project revenues and labor costs are supported by market/industry information and historical financial statements.

3. Determine if project meets minimum public benefit requirements (one full-time equivalent job for every $35,000 in RLF.